THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 366 **DECEMBER 2003**

In order to discover the immediate — the short-run — effects brought about by some event in the economy, there is as a rule no need to resort to a thorough investigation. They are for the most part obvious and seldom escape the notice of a naïve observer unfamiliar with searching investigations. What started economic studies was precisely the fact that some men of genius began to suspect that the remoter consequences of an event may differ from the immediate effects visible even to the most simple-minded layman. The main achievement of economics was the disclosure of such long-run effects hitherto unnoticed by the unaffected observer and neglected by the statesman.

— *Human Action: A Treatise on Economics*, Ludwig von Mises,
Yale University Press, 1949

WHEN CONFIDENCE BREAKS

Good news about the U.S. economy is proliferating. The international media is littered with articles stating that the U.S. economy is forging ahead with rapidly rising profits. Yet neither the stock markets nor the currency market have taken any notice. Asking traders, nobody could offer a plausible reason. Yet there are two very simple tentative explanations: *first*, the economic news is good, but not good enough to meet the high-riding expectations; and *second*, the bulls are fully invested, and short-covering by the bears is finished.

Better-than-expected economic news, actually, is coming from all parts of the world. Asia, accounting for 24% of global GDP, is hitting 7.7% growth this year. Ex Japan, the economies are firing on all cylinders, with growth rates vastly outpacing current and expected U.S. GDP growth. The tiger in the group is China, with expected 11.5% growth this year. Common to all these countries are high levels of gross national saving, including depreciations (averaging almost 30% of GDP), and also high levels of gross investment (averaging between 22–23% of GDP).

The U.S. economy, accounting for a quarter of the world's GDP, is likely to finish 2003 with GDP growth of 2.9%. Gross national saving is hitting a low of 13.5%, while gross investments in the past few years have been hovering around 18% of GDP.

The euro area, accounting for 18% of global GDP, will exit the current year with barely 0.5% GDP growth. Both gross domestic savings and gross domestic investment equal on average between 20–21% of GDP.

While U.S. economic growth is increasingly lagging Asian growth, the global focus remains primarily on the U.S. economy as the world's supposed predestined locomotive, for the apparent reason that America's consumer is the world's greatest spender. Implicitly, the U.S. current-account deficit of about $560 billion per year reflects what Americans spend in excess of their current production and income.

Yet the Asian countries, ex Japan, have a second reason to run a surplus with the United States. It is the main source of the high-powered money of their banking systems. As their central banks are buying gargantuan amounts of surplus dollars, they create liquid reserves for their banks that foster the lending boom to their domestic producers. Vastly excessive reserve growth is creating vastly excessive money and credit growth, stimulating and financing an unprecedented investment boom, similar to that in Japan in the late 1980s.

Global activity data has kept surprising on the upside for months, and there has even developed speculation that unexpectedly strong global economic growth may fuel considerably higher inflation rates. Commodity prices, in the past generally an early indicator in this respect, have soared spectacularly. Given, moreover, years of extremely rampant money and credit growth around the world, accelerating inflation

will be the next great surprise for many people.

All this raises many questions. It seems quite feasible that the Asian tigers, with their record-high savings and investment ratios, will continue to power ahead with runaway credit creation. Yet our fear rather is that some of them, in particular China, may derail into Japan-style bubble economies.

For us the greatest uncertainties are about the U.S. economy, its financial system and its currency. The great issue not only for America but also for the global economy is whether the U.S. economy has definitely reached the stage where economic growth has become self-sustaining. Or whether it may relapse into sluggish growth next year, if not recession. Looking at the markets, we have the impression that many people are struggling with this question.

WAS IT THE PEAK?

On the surface, the report of real U.S. growth of 7.2% in the third quarter, later revised to 8.2%, was most impressive. Many commentators hailed it as the highest growth rate since 1984.

To us, the exciting growth number raised more questions than it answered. Yes, it was the U.S. economy's fastest sprint in 19 years. At the time, it was actually 7.3%, but this rate referred to GDP growth over the whole year. This time, it was an annualized quarterly growth rate of 2%, which is not always meaningful.

Considering that the U.S. economy's long-term growth potential is around 3%, it should be clear that after three years, during which annual real GDP growth has averaged 1.8%, it still needs a lot more demand and growth acceleration to remove the output gap that has accumulated in these years.

It is furthermore generally agreed that a sustained and sufficiently strong recovery of the economy is only possible with a prompt, brisk rebound of business fixed investment. The bullish consensus is satisfied that this is happening.

As reported, nonresidential business investment rose in the third quarter of 2003 by 11%, after 7.3% in the second quarter. For sure, these are impressive numbers, but the only thing that gives them this strength is the American practice to annualize quarterly numbers. The true nonannualized growth rates of 2.75% and 1.8% for the two quarters would have caused nothing but yawns.

But there is a second big snag in the reported investment numbers. As usual, it arises from the familiar statistical spin concerning the measurement of business investment in computers.

In real terms, or "chained" dollars, it increased over the full year until the third quarter of 2003 from $297.6 billion to $390.3 billion, that is, by $92.7 billion, of which $35.4 billion occurred in the third quarter. That is the statistical fiction; actual business spending in current dollars on computers increased over the same time by just $11.5 billion, from $76.8 billion to $88.3 billion, of which $5.9 billion was in the third quarter.

In reality, measured in current dollars, nonresidential investment over the year increased overall by $46.2 billion. Among this total, computer investment soared by $93.1 billion, of which $81.6 billion came from the hedonic spin.

Each additional dollar spent on computers in the real GDP accounts during the year translated into eight additional "chained" dollars, accounting, by the way, for 26% of real GDP in this time. The difference between the two measures of business computer investments is exploding. So much for the trumpeted investment recovery.

As we have explained many times, these particular dollars are fictitious dollars that nobody has paid

and nobody received. Manifestly, such dollars inherently also add nothing to profits.

Putting it briefly and bluntly: The trumpeted brisk rebound in U.S. business capital investment is another bullish mirage lacking any serious substance.

REALITY CHECK

But what about the extraordinary burst in real GDP growth during the third quarter? Has that not completely changed the picture? A few days after the release of these data, Treasury Secretary John Snow gave an enthusiastic address to the Economic Club in Washington. He said, "*It seems clear that we have entered a new phase of economic expansion... This is not a fleeting glimmer — there is real muscle behind the growth trend.*"

The fact is that multiple one-off stimuli were converging on the U.S. economy — the housing bubble, the mortgage refinancing bubble, tax cuts, auto sales promotions and the rallying stock market.

The main drivers, measured in real terms or chained dollars, were personal consumption, business investment in computers, residential building and purchases of autos both by consumers and businesses.

But on closer look, the GDP growth in the third quarter had one overwhelming source, and that was consumer spending on two counts: consumption and homebuilding, accounting together for 76.3% of the recorded overall GDP growth.

A NEW PATTERN OF GROWTH

On the surface, it looked like America's familiar growth pattern — consumption-driven. Yet something had drastically changed during the past two years, and that was the financial source of consumer spending. As a rule, of course, the consumer mainly spends what he earns, with borrowing as a marginal contributor.

But this financing pattern has been put on its head. The protracted consumer-spending boom that developed during the late 1990s got its financial push increasingly from asset bubbles, highly appreciated in America nowadays as wealth creation. Over time such wealth creation has advanced to his main source of finance.

During the third quarter of 2003, consumer spending on goods and services increased — nonannualized — by $27 billion, comparing with a simultaneous increase in personal incomes by $22.7 billion, of which wage and salary income accounted for a miserable $7.1 billion. This source of income in the United States has virtually collapsed, reflecting the dismal performance of production and employment.

Normally, this would have similarly clipped consumer spending. But a kind of "new paradigm" monetary policy has managed to replace the lacking traditional "income-driven" consumer spending largely by "wealth-driven spending."

"Wealth-driven spending" is a completely new term in economics, invented in America. What it means is nevertheless crystal clear: increases in spending that are fueled by rising asset prices, providing the collateral for higher borrowing, are now in America positively perceived as "wealth-creation."

This new pattern of wealth-driven consumer spending started with the long and steep rise in stock prices in the later 1990s. What truly matters, though, is not the rise in asset prices, but the borrowing and spending binge that it facilitates and unleashes. In the U.S. case, the protracted stock market boom shattered personal saving from current income. Regarding the gains in the market as a fully valid substitute, Americans stepped up their spending at the expense of such saving.

Wealth-driven economic growth is, of course, a better-sounding synonym for bubble-driven growth. After working smoothly between 1997 and early 2000, both the asset and borrowing-and-spending bubbles

suddenly burst in quick succession. As stock prices collapsed and the economy continued to weaken during the year, the Federal Reserve decided to fight both with rapid, drastic rate cuts, starting on Jan. 3, 2001.

Real GDP growth returned in the fourth quarter of 2001 with an annual rate of 2.7%, followed in the first quarter of 2002 by an impressive growth rate of 5%. But instead of accelerating, the economy relapsed into new, protracted sluggishness.

Although massive fiscal stimulus joined the massive monetary stimulus, economic growth slowed during the winter of 2002–03 to 1.4% at annual rate. It was plainly obvious that the economy's anticipated recovery had definitely aborted, and for sure, this was fully recognized within the Federal Reserve.

TARGETING THE BOND BUBBLE

We are not sure that they precisely planned what followed. Ruminating in public about deflation risks lurking in the U.S. economy and the urgent need to fight this most dangerous evil, leading members of the Federal Reserve Board began in mid-2003 to convey to the markets two messages about future monetary policy: *first*, an explicit commitment to maintain the existing extraordinary monetary ease with short-term interest rates at 1% for a long time to come; *second*, that the Fed was pondering "unconventional measures" to also lower long-term interest rates to give its monetary ease more traction.

It was an obvious attempt to manipulate bond prices higher and their yields lower by inciting a buying frenzy of longer-term bonds, and it was also clear as daylight right from the beginning that in an economy without savings, this could only take place through highly leveraged carry trade.

Given a huge and highly vigilant speculative community in the United States, the desired bond bubble promptly kicked in. Holdings of long-term bonds, yielding 4% and more, are financed (carried) by borrowing in the money market with Fed funds, LIBOR or REPO money at around 1%. Leverage of about 20-to-1 is typical.

For only 5% down, the carry play trader is able to run massive bond positions. With an interest rate spread of 3–4% between his interest costs and his interest revenue from his bond holdings and 20 times leverage, he makes between 60–80% per year on his invested equity capital.

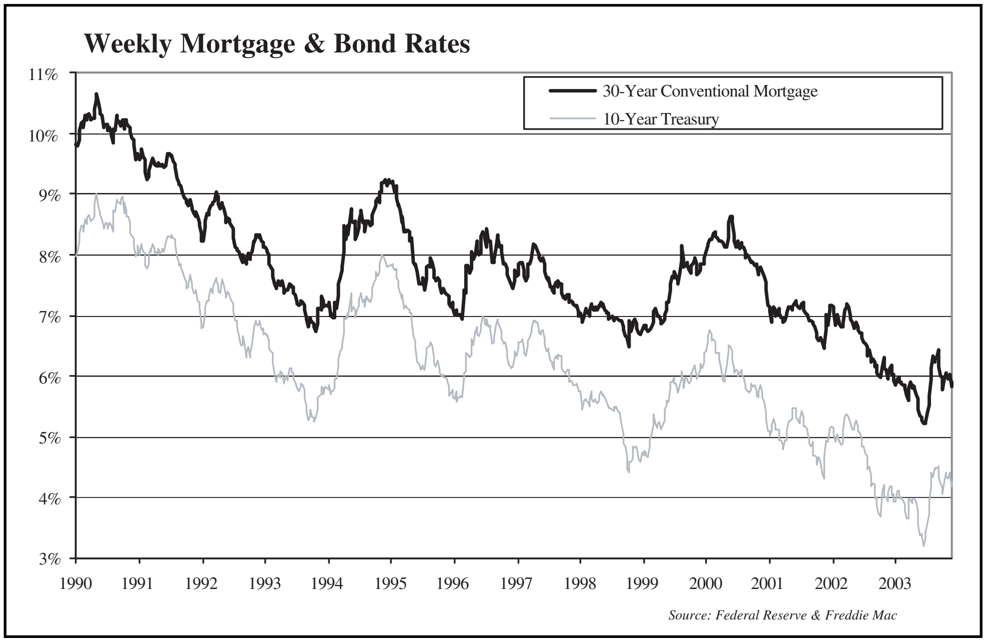
As to be expected, the financial community immediately and drastically obliged. Within just weeks, the yield of 10-year government bonds slumped from a little over 4% to 3.1%, according to reports its lowest level in 45 years. Instead of buying long-term bonds on its own account, ambiguous Fed talk had managed to put the financial community before the interest cart.

A FALSE COMPASS: INFLATION RATES

Intrinsically, all this hinged crucially on generous accommodation by the Federal Reserve, holding short-term rates firmly at 1% despite the associated borrowing binge. Of course, the Fed obliged, and it keeps obliging with repeated public assurances to hold short-term rates at their rock-bottom level as far as the eye can see. Few people seem to think that artificially low interest rates tend to do harm in the long run.

Actually, today there is a widespread perception, particularly in the United States, that in the face of low inflation rates, interest rates cannot be low enough. Implicit to this view is the further perception that low inflation inherently reflects and makes for financial and economic stability.

The irony is that economic and financial problems have been proliferating as never before since the low inflation rates arrived. While the virulence of the business cycle has receded, booms and busts in asset markets have become more frequent, breeding dangerous financial instability.



It goes without saying that the low inflation rates, as such, are not the villain. The villain has been a sea change in thinking at central banks and in the markets about the essence of monetary and financial stability.

For generations, it used to be the undisputed consensus view that economic and financial stability had their indispensable key condition in a balance between available savings and credit growth. Inflation of credit in excess of available savings was the permanent main concern in central banks and in the markets. Most of the time inflation of prices was no problem.

With the arrival of high inflation rates and in particular the change from fixed to flexible exchange rates, this thinking about tolerable credit creation changed radically in the 1970s. It led central banks to focus their policy primarily on fighting the rampant price inflation.

At first, it was done with targets of money growth. But when money growth went into permanent and growing excess to the targets while inflation rates continued to fall, those targets were soon abolished and forgotten. The idea gained ground that low inflation rates, as such, should be the key gauge and target of monetary policy.

In due time, it became the new consensus view that low inflation rates are the direct route to economic and financial stability. Some central banks, among them obviously the Greenspan Fed, drew the conclusion that low inflation rates allow totally unrestrained credit expansion, and so it happened above all in the United States.

In 1973, the switch from fixed to flexible exchange rates removed another, formerly most important, brake to monetary policy. Under fixed exchange rates, central banks and markets had been extremely sensitive to any small deterioration in the current account of a country's balance of payments. Minimal deficits promptly put a currency under pressure, forcing the central bank to check credit expansion.

As a result, the system of fixed exchange rates had exerted a strict monetary discipline around the globe, including even the United States, running a permanent surplus in its current account until the early 1980s.

The actual final outcome of this shift in the exchange rate system was that the markets and some central banks — among them in particular the U.S. Federal Reserve — turned a blind eye even to soaring deficits in the current account. Incidentally, America's financial system became a system without any external constraint to credit expansion.

IDENTIFYING A BUBBLE

The old central bankers, as already mentioned, were always mindful of the necessary balance between available domestic savings and credit expansion. For them an early indicator of a developing imbalance between the two aggregates was a deteriorating trade balance, responding typically long before prices.

It is, as a matter of fact, the central axiom of Austrian theory that the movements in the price level can be a misleading guide to monetary policy. What crucially matters is the inflation of credit, exerting a much deeper and fundamental influence on the whole economy through distortions and dislocations in its whole demand and output structure.

From a policy perspective, to stress the key point, the decisive evil thing is the credit expansion that exceeds available domestic savings. That is the regular, cardinal culprit behind all dangerous economic and financial imbalances, and also behind all inflations. What the Greenspan Federal Reserve refuses to accept is that their beloved wealth-creation reflects incredibly dangerous inflation in the asset markets.

Putting it differently, in a balanced economy, credit expansion is fully matched by available domestic savings. This used to belong to the elementary knowledge of economists. Mr. Greenspan shocked us with his public remark that an asset bubble can only be recognized after it has burst. Outrageous credit inflation was the infallible and most spectacular hallmark of America's equity bubble in the late 1990s. But instead of feeding into the price indexes of goods and services, which continued to fall, it fed into soaring imports and soaring stock prices.

To repeat: All asset bubbles and bubble economies have their highly visible and also compelling trademark in exploding credit. The distinction between the two is important. An asset bubble simply reflects a rise in asset prices out of proportion to underlying yields. A bubble economy is an economy where soaring asset prices fuel a borrowing/spending binge that may be concentrated in real estate, business fixed investment or consumption.

A SHOCKING COMPARISON

In the discussion about the U.S. economy, it has been repeatedly mentioned that interest rates are at their lowest in 45 years. It made us curious about differences in the underlying conditions in the two periods. It was a most interesting exercise.

The common feature is low inflation rates. But in every other respect, the comparison reveals radically different economic and financial universes, and also radically different causes for the record-low rates.

In 1959, the private sector's total net savings amounted to $44 billion, of which personal saving accounted for $26.5 billion and business saving (undistributed profits) for $17.5 billion. With the government sector in surplus by $21 billion, the three components added up to net national savings of $61.1 billion, or 12% of GDP.

Imagine: In 1959, the business saving rate net of depreciation — undistributed profits, in other words — was 3.4% of GDP. Compared to today's GDP, that would amount to undistributed profits of around well over $350 billion.

And today? The reality during the third quarter in the case of the nonfinancial sector was $49 billion in the negative. American businesses are dissaving, and so is, of course, the government sector with the soaring federal deficits. According to National Income and Product Accounts statistics, private households are running a savings surplus, but looking at the rampant housing and mortgage refinancing bubble and considering that saving represents in essence unspent income, we wonder how that surplus comes about. All in all, it seems a fair guess that today's America has gotten rid of any savings.

If the difference in savings between the two periods is ludicrous, the difference between credit growth defies description. In 1959, total net borrowing in the United States increased by $56.8 billion, perfectly in line with available net national savings of $61.1 billion. For perspective, nominal GDP increased by $39.5 billion to $507.4 billion.

Now to the credit horrors of the present. Keep in mind: Net national savings are at best close to zero, if not negative. Nonfinancial borrowings ballooned in 2002 by $1,374.6 billion, of which $771.8 billion was on account of the consumer. For perspective, this was about seven times the simultaneous GDP growth of $364 billion.

We have drawn this comparison between the two periods not just by impulse. We think it is most important to realize the incredible difference that exists between today's financial conditions in the United States and those of the past.

In the late 1950s, America's record-low interest rates were clearly and soundly founded in high domestic savings and moderate credit growth. Today's record-low interest rates are just as clearly founded in unprecedented monetary looseness accommodating unprecedented financial leverage.

TARGETING ASSET BUBBLES

The relevant issue, however, is not the bubble as such, but what happens in its wake to the real economy and the financial system. In general, policymakers have become fearful of asset bubbles. America is the only country in the world where asset bubbles have become the panacea of monetary policy.

Earlier we described how the Fed launched the bond bubble. Given the close institutional link between government bond yields and mortgage rates in the United States, the plunging bond yields quickly translated into plunging mortgage rates which, in turn, incited private households to two vigorous responses.

One was to stampede into house purchases, old and new, driving up house prices. The other one was to stampede into plunging mortgage rates that lending institutions offered through generous facilities of mortgage refinancing, combining it with massive equity extraction. As a result, three interrelated bubbles developed — in bonds, in house prices and in mortgage refinancing.

Mr. Greenspan, in a speech in Orlando on March 4, 2003, to Independent Community Bankers, explained with obvious satisfaction that house owners had extracted built-up equity of about $700 billion from their homes in 2002, or more than 10% of estimated equity at the beginning of the year. But thanks to sharply lower interest rates realized through the mortgage refinancing, he emphasized, mortgage debt service costs had little changed. Total personal income, by the way, grew during the year by $236.9 billion.

In the third quarter, private households reaped another major financial windfall from fiscal policy through tax cuts and child-care credit checks, both measures being centered in July and August. Their before-tax incomes grew $22.7 billion. But the fiscal measures boosted that to an increase in disposable incomes by $47.7 billion. Consumer spending on goods and services rose by $41.9 billion.

The figures generally mentioned are much higher. That is because they are annualized. According to them, before-tax incomes surged in the quarter by $91 billion and disposable after-tax incomes by $191 billion. By these numbers, the tax cuts in the quarter amounted to $100 billion. We prefer the nonannualized figures.

In reality, there was still a third extraordinary stimulus at work during the quarter: a new wave of auto sales promotions. Sales of new autos to consumers swelled, annualized, in real terms by $30.7 billion, and sales to businesses by $9.4 billion, accounting together for 24% of the reported real GDP growth.

THE CRUCIAL DRIVER — PENT-UP DEMAND

So, was the third quarter a blip or a sustained economic recovery in its early stage? That is, of course, the cardinal question.

Generally speaking, the safest thing to say about the U.S. economy's performance in the third quarter

of 2003 is that there was nothing typical. Nor, of course, was there anything typical in what happened during the prior two years since the 2001 recession. The pattern of economic development since the bursting of the equity bubble in spring 2000 has no precedent. For us this is a key consideration telling us that the old business cycle model is of no help in assessing the present situation.

The typical postwar economic downturn was determined by three preceding key features: inflation, the credit crunch and pent-up demand. What typically happened was that during an economic upturn, aggregate demand outstripped aggregate supply, stoking accelerating inflation. Slamming on the brakes, the central banks slowed overall spending, which invariably culminated in recession. As inflation subsided, they took the brakes off again, and the pent-up demand that had accumulated during the recession promptly exploded, tracking the regular V-shaped recovery.

Manifestly, the accumulation of pent-up demand during past recessions used to be crucial for the later prompt, strong economic upturn. And importantly, too, it was always pent-up demand across the whole economy — in consumption, in business investment, in building and in inventories.

What has happened during the last several years is in every respect the exact opposite. The U.S. economy's downturn started in the face of rampant money and credit growth, essentially implying that it had other causes than tight money. Unprecedented monetary and fiscal stimulus in the following three years unquestionably prevented worse in the short run.

But it was a double-edged policy from a long-term perspective. Instead of generating pent-up demand with tight money as in the past, the extraordinary monetary and fiscal looseness of the last few years lured the consumer to borrow heavily, and for sure, it was borrowing from the future.

This difference concerning the consumer between large-scale "pent-up" demand in past business cycles and the present spending that "borrows from the future" is one of the most important considerations in doubting the possibility of a truly sustainable U.S. economic recovery.

It reminds us of a sarcastic remark by Mises: "*It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises*."

THE GREAT DISCONNECT

Preventing worse in the short run is certainly important. Yet the truly decisive question is, of course, the long run, and how the short-run policies are affecting it. In principle, times of recession are times of remedying the economic and financial maladjustments that have accumulated in the economy and its financial system during the prior boom, and that have led to the economy's downturn. In this way, the economic downturn usually clears the decks for the coming recovery, the next bull market.

The consensus view in America apparently sees only one decisive growth-impairing problem: lack of demand. All those interest rate and tax cuts of the past few years pursued the one goal to bolster domestic demand, in particular consumer demand, expecting that its rise would stimulate investment spending and production.

Well, demand growth was achieved. Yet considering the extraordinary monetary and fiscal largesse, we have to say that we find its actual traction on the economy most disappointing. Consider that real GDP growth in 2003 will be 2.9%, after 2.4% last year.

The calamitous point to see is an unprecedented disconnect in the U.S. economy between apparent strength on the demand side and persistent sluggishness on the supply side. Despite all the monetary and fiscal stimulus measures, investment, production and employment refused to respond. What did respond was consumption and asset markets.

Manifestly, the ultra-easy monetary policy had its primary effect in creating asset bubbles, which, in turn, fuel the consumer's borrowing and spending binge. Expressing it in the Fed's language: We create wealth-driven consumer spending.

This gross lack of traction is the one disastrous failure of these policies. But there is a second one of even worse nature. It concerns the economy's micro and macro fundamentals. With more and more monetary looseness, they are going from bad to worse.

STILL MORE MALADJUSTMNTS

Stating this, we have our eyes on the vanished national savings, on the soaring budget deficit, on the monstrous and still growing trade deficit, on further soaring indebtedness and on the protracted, dismal development of business investment, production, incomes and profits.

Looking for a recovery, we focus in particular on manufacturing. Successful demand creation shows first of all in rising industrial production. Normally, it is the first component in the economy to rise sharply. Last October, it was up 0.6% year-over-year, as against real GDP growth of 3.3%.

Earlier we pointed out that the American consumer's heavy "borrowing from the future" in the past few years will tend to obstruct the economy's expected recovery. This great disconnect that has developed between demand creation and production growth is another thing that greatly disturbs us. This has no precedent, and it is difficult to explain. One obvious cause is, of course, the growing import penetration, but that has sharply slowed in comparison to past years.

There is a widespread view that employment is faring so poorly because of the stellar productivity growth. But this does not explain why production and incomes also remain so sluggish. High productivity growth ought to show in high income growth, even with falling prices. But real wage gains have collapsed from about 6% in 1998 to virtually zero. For us, a reported productivity miracle that fails to show in incomes or profits is essentially another meaningless statistical hoax.

According to the latest reports, corporate profits are surging. The general explanation is drastic labor-shedding and productivity growth. Yes, but what raised business revenues was the bubble-driven rise in consumer spending, and that is subsiding. In addition, we suspect big profits from financial speculation and leveraging.

THE NEXT SURPRISES

Looking forward, the main question, of course, is whether or not the global recovery is finally under way. Hopefully, we have made it clear enough that we are more than skeptical. For us, the greatest unpleasant surprises and the greatest dangers are looming in the United States.

By past experience, the lately proliferating good news about the U.S. economy ought to have boosted the dollar and global stock markets. Instead, the dollar has been falling in a broad range against many currencies, while the global stock market rally has abruptly faltered. It also strikes us as most ominous that the gold price is now rising out of control.

If we had any faith in the rationale of stock markets, we would presume that this surprising change in their behavior owes to a general realization that the U.S. economy has seen its peak and that it can only weaken from this level.

In our view, all questions about the U.S. economy in 2004 boil down to the one question of what will happen to the economy's two pillars of support during 2002–03 — the housing price bubble and associated mortgage refinancing frenzy. Apparently, Mr. Greenspan could not be more pleased about his successful policy.

In the same vein, he keeps stressing that any analogy with the earlier stock market bubble is misplaced because when selling a home, one almost invariably must move out with considerable transaction costs. A study published by the International Monetary Fund in April 2003 within its semiannual report came to the exact opposite conclusion that busts of housing prices were associated with far greater damages and output losses than equity busts.

Assessing the U.S. economy's prospects, one question appears paramount, and that is whether and how quickly the consumer spending bubble will lose its crucial support from the housing and mortgage refinancing bubble.

There seems to be a widespread view that all bubbles will keep working well into 2004, and that investment spending will meanwhile kick in. The typical arguments are that housing demand and, hence, the rise in house prices, are holding up well and that mortgage rates, though up from their record lows, remain at unusually low levels.

Beware of bubbles; they have a bad habit of bursting suddenly. We assume that all bubble support to consumer spending has definitely finished. This support came mainly from the huge equity cash-outs — in 2003 around $95 billion — linked with mortgage refinancing. But low interest rates are not enough to maintain these cash-outs. It needs falling mortgage rates. Lowering the interest rate expenses on *existing* mortgages is the key point in the process.

HORRIBLE DOLLAR FUNDAMENTALS

It is easy to see why the dollar's broad and recent slightly accelerating decline is not causing any fretting in Washington. So far, first of all, it has been gradual, and second, the continuing huge capital inflows are financing at one stroke both the trade and the budget deficit, and also importantly help to keep interest rates low.

Nevertheless, there have since 2000 been two drastic changes in the pattern of U.S. capital inflows: *first*, foreign equity buying and direct investment, the predominant flows in the late 1990s, are completely out and replaced by foreign bond purchases; *second*, sharply falling capital inflows on private account have been offset by bond purchases of foreign central banks, amounting over the 12 months till October 2003 to almost $200 billion.

Yet what amazes us is not how much, but how little, the private capital flows into the United States have declined. After all, America offers the lowest interest rates in the world, next to Japan and Switzerland. In the 1980s, in the face of a soaring trade deficit the strong dollar had the support of high interest rates.

In past letters, we have repeatedly stressed and explained that the huge U.S. current-account deficit is, in our view, the most dangerous imbalance in the U.S. economy. It is one of the main reasons for the economy's persistent sluggishness, and if it lasts, it will at one point pull the rug out from under the dollar and the U.S. financial system.

For the American consensus, the huge and growing trade deficit has two main causes that are both the fault of foreigners. The primary cause, in this view, is the eagerness of foreigners to invest in the U.S. economy, driving up the dollar; and the second major foreign fault is their common failure to create sufficient domestic demand in their own countries.

As to the first argument, it is hard to understand how such a ridiculous idea could be taken seriously. A sharply rising dollar, driven by capital inflows, is definitely not prone to stimulate domestic spending in the United States. Rather, it curbs investment spending, and, hence, also consumer spending.

Just as flawed is the second argument that elevates the trade deficit virtually to an emblem of strong economic growth. In actual fact, the historical truth is rather the opposite, that fast-growing economies typically have a trade surplus. Outstanding cases in the postwar period were Germany and Japan, for two obvious reasons: high domestic savings exceeded high domestic investments.

In 1990, Japan's corporate sector, investing like crazy, ran a financial gap of 9.1% of GDP. Yet the country's trade balance remained in large surplus because private households and the government matched the huge corporate deficit with an even higher savings surplus of 10.7%.

What a trade deficit reflects, in essence, is an output–spending gap; and what a trade surplus reflects, in essence, is an output-spending surplus. Usually, high-growth economies have both high savings and investments, and that is why they usually also run a trade surplus. In Asia today, it is not the low wages that generate the trade surpluses. It is the high rates of saving in these countries.

In contrast, the big U.S. trade deficit mainly reflects four things: (1) unfettered credit excess; (2) overconsumption; (3) undersaving; (4) underinvestment. The common cause is the unbelievable monetary looseness that the Greenspan Fed has been pursuing since 1997, and the most important point to see is that more of the same monetary looseness does not heal them but can only worsen them.

The optimistic consensus now expects that a gradually falling dollar will slowly reduce the trade deficit without too much pain. As it so often does, badly flawed wishful thinking rules the discussion. We have to warn that a lower dollar does nothing to fix the structural displacements. The U.S. economy's great problem is not the exchange rate but frenzied credit and debt excess overwhelmingly geared to finance consumption and speculation.

But what exactly caused the strong dollar, and what is bound to cause its steeper fall? In the view of the consensus, there is a high-grade correlation between strong economic growth and a strong currency. It is another assumption that is too good to be true. What manifestly lured foreign investors and firms to their frenzied buying of American shares was the stock market bubble and the belief in a "new paradigm" U.S. economy delivering a profit and productivity miracle.

The equity bubble, for years the powerful magnet for foreign capital, has burst. Instead of a profit miracle it brought a profit carnage. Not quite surprisingly, foreign stock purchases have collapsed. Heavy buying of Treasury and agency bonds, mainly by Asian banks, took their place. Rather puzzling in view of the low U.S. interest rates, foreign bond purchases on private account, too, continued at a high level. Capital gains from the bond bubble, we presume, played a role.

All this leaves us with a question that we regard as the most important one for the world at this juncture: What will decline first and faster? The U.S. trade deficit or U.S. capital inflows?

Apparently, U.S. stocks and the dollar have been enjoying strong support in the past few months from the widespread belief that the U.S. economy is firmly on the road to a sustained recovery. But even though more and more recent economic data seem to confirm this view, stocks have lost their momentum while the dollar was slumping.

But what exactly caused the strong dollar and is going to cause its still deeper fall? There is a widespread view in the United States that the strong dollar of the past few years had its key cause in the U.S. economy's superior growth performance. From this perspective, the impending U.S. economic recovery is sure to restore a stronger dollar.

It is another assumption that is too good to be true. What lured foreign investors and firms to their frenzied buying of American shares during the late 1990s was the stock market bubble and the erroneous

belief in a "new paradigm" U.S. economy delivering miracles of productivity and profits. The key cause of the strong dollar was the profit delusion, and with that delusion shattered, there is no hope for a return of heavy foreign buying of U.S. stocks.

Heavy buying of Treasury and agency bonds mainly by Asian central banks has taken their place. Rather puzzling in view of the low U.S. interest rates, foreign bond purchases on private account, too, have continued at a high level.

All this leaves us with the question that we regard as the most important one for years to come: What will happen to the dollar? Is hard lending possible? A general belief that the U.S. economy is firmly on the road to sustained recovery has been keeping a floor under stock prices and the dollar.

CONCLUSIONS:

Our conclusions start with the assumption that the U.S. economic recovery peaked in the third quarter. The consumer spending bubble is sure to deflate with the mortgage refinancing bubble, and that will nip any rebound in business investment in the bud.

Our mistrust of a possible sustainable economic recovery has a basic reason in the fact that the bubble-related excesses and imbalances that have accumulated in the bubble years — the yawning trade deficit, overconsumption, undersaving and overindebtedness — have not been addressed at all.

Fighting the harmful legacy of credit looseness with still more credit looseness, the Greenspan Fed increasingly destabilizes the economy and the financial system.

Comparing the prodigality of the monetary and fiscal stimulus with the economy's actual subpar growth of 2.9% in 2003, after 2.45% in 2002, we regard this as an atrocious policy failure.

Considering the various severe and mostly worsening maladjustments in the U.S. economy and its financial system, we do not think a genuine economic recovery is possible.

It strikes us that there still is general strong confidence in the U.S. economy's ability to overcome its present problem through massive monetary and fiscal stimulus. It is our view that a failing economic recovery will nevertheless break this confidence with devastating effects on the markets and the dollar, as the realization dawns that the power of aggressive policy ease has been spent.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by Agora Publishing Inc.
Jeanne Smith, Publisher
Richard Barnard, Associate Editor
Emily K. Phillips, Editorial Assistant
Mark O'Dell, Design & Layout

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (800) 433-1528, or from outside the U.S. by calling (203) 699-2900. Fax (410) 454-0403. Web: http://www.richebacher.com Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.